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No. 07-1002

IN THE
Supreme Court of the United States

EL TORO MATERIALS COMPANY, INC. and KAREN SUE NAYLOR, CHAPTER 11 TRUSTEE

Petitioners,

v.

SADDLEBACK VALLEY COMMUNITY CHURCH,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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REPLY TO BRIEF IN OPPOSITION

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Petitioner El Toro Materials Company, Inc.[1] ("El Toro") respectfully submits the following reply to the Brief in Opposition filed by Respondent Saddleback Valley Community Church ("SVCC") in response to El Toro's Petition for Writ of Certiorari.

A. The Ninth Circuit's Decision Is Inconsistent With *TreeSource*.

Contrary to SVCC's assertion, there is a glaring inconsistency between the Ninth Circuit's decision in *Saddleback Valley Community Church v. El Toro Materials, Inc. (In re El Toro Materials, Inc.)*, 504 F.3d 978, 981 (9th Cir. 2007) and its opinion in *K-4, Inc. v. Midway Engineered Wood Products, Inc. (In re TreeSource Indus., Inc.)*, 363 F.3d 994 (9th Cir. 2004).

In *TreeSource*, the Ninth Circuit Court of Appeals ruled that a debtor's failure as a tenant to remove debris, repair and maintain property, and restore the property to its pre-lease condition arose "upon termination or expiration of The Lease." *In re TreeSource Indus., Inc., supra*, 363 F.3d at 998. As the Court of Appeals observed:

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[1] As noted in the Corporate Disclosure Statement in its Petition for Writ of Certiorari, El Toro has no parent corporation and no publicly held corporation owns 10% or more of El Toro's stock.

> The termination or expiration of the lease occurred when Midway rejected the lease..... Therefore, the resulting damage action for Midway's failure to comply with the Removal Obligation is treated as a pre-petition general unsecured claim for rejection damages ....

In re TreeSource Indus., Inc., supra, 363 F.3d at 998.

Although the Ninth Circuit conceded that "[t]he cap applies to damages 'resulting from' the rejection of the lease" *in El Toro*, the Court ruled that SVCC's damage claims, based upon El Toro's failure to remove the mining residue and restore the leased property, were not lease rejection damages and therefore were not capped. *In re El Toro Materials, Inc., supra*, 504 F.3d at 980.

Though *Treesource* did not consider the cap in its analysis, it did determine what constitutes rejection/termination under the rejection statute (§ 365) which is the starting point in determining whether the § 502(b)(6) cap applies. The two sections must be read together. *In re PCH Associates*, 804 F.2d 193, 199-200 (2d Cir. 1986); see also *In re Moreggia & Sons, Inc.*, 852 F.2d 1179, 1182 (9th Cir. 1988).

The only distinction between the cases is the fact that SVCC asserted nuisance, waste, and trespass damages claims in addition to breach of lease claims. As the Bankruptcy Appellate Panel noted, however, SVCC's tort claims were "based upon El Toro's failure to remove the mining residue from the leased property, conduct that SVCC in its proof of claim concedes constitutes a violation of the lease." Petitioner's Appendix D, p. A-51.

This fact was central to the BAP's conclusion that the § 502(b)(6) cap applied to SVCC's alleged tort claims. Petitioner's Appendix D, p. A-51. The Bankruptcy Appellate Panel's ruling was "based upon the language of the Bankruptcy Code, the interpretations previously given this provision by this Panel, and, importantly, is required by the critical undisputed facts of this case." *Id.*

B. The Ninth Circuit's Decision Conflicts With The Text Of The Statute.

According to the Bankruptcy Appellate Panel, the language of Bankruptcy Code § 502(b)(6) "is simple and not ambiguous." Petitioner's Appendix D, p. A-52. "The words in the statute do not distinguish between a lessor's claims founded upon contract, tort, statute or some other legal basis." *Id.* "If the lessor holds a claim for 'damages,' the claim is capped." *Id.*

Although SVCC and the Ninth Circuit Court of Appeals pay lip service to the rule that the plain meaning of a statute controls statutory interpretation, both ignore the fact that Bankruptcy Code § 502(b)(6) caps a lessor's claims for "damages resulting from the termination of a lease." The cap does not apply solely to "rent" or to "contractual" damage claims.

While SVCC's contention that "Congress knows how to address tort claims when it intends to affect them" is certainly true, it is a surprising admission on SVCC's part since it supports El Toro's interpretation. The text of Bankruptcy Code § 523 makes it clear that Congress understands the distinction between contract and tort claims and knows how to except tort claims from the scope of statutes of general application such as the discharge of debts.

The fact that Congress did **not** exclude tort claims from the damages cap contained in Bankruptcy Code § 506(b)(6) suggests that the omission was not inadvertent. "[T]he Court must presume that Congress acts intentionally and purposefully when it includes particular language in one section of a statute but omits it in another." *In re LaPlana*, 363 B.R. 259, 265 (Bankr. M.D. Fla. 2007).

Realizing that the statutory language and legislative history support El Toro's position, SVCC asks the Court to envision a series of increasingly alarming hypothetical scenarios in an attempt to prove on public policy grounds that Congress could not possibly have meant what it said or said what it meant when it enacted Bankruptcy Code §§ 365(g), 502(b)(6), and 502(g).[2] The first of these hypotheticals is taken from the Ninth Circuit Court of Appeals' opinion in *El Toro*.

In an attempt to prove that following the plain meaning rule in interpreting the statute would lead to absurd results, the Ninth Circuit warned that extending the cap to cover collateral damage "would allow a post-petition but pre-rejection tenant to cause any amount of damage to the premises -- either negligently or intentionally -- without fear of liability beyond the cap." *In re El Toro Materials, Inc., supra,* 504 F. 3d at 981.

The Court offered the following example:

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[2] These statues provide that the rejection of an unexpired lease constitutes a breach of the lease "immediately before the date of the filing of the petition," treat the claim arising from the breach of the lease as a prepetition claim, and cap this prepetition, general unsecured claim using a formula based upon a proportion of the rent reserved in the lease.

> If the tenant's debt to the landlord already exceeded the cap then there would be no deterrence against even the most flagrant acts in violation of the lease, possibly even to the point of the tenant burning down the property in a fit of pique. Absent clear statutory language supporting such an absurd result, we cannot suppose that Congress intended it. *Id.*, 504 F.3d at 981.

Bankruptcy Code § 502(b)(6) caps the claim of a lessor "for damages resulting from the termination of a lease of real property ...." Arson damages do not result from the termination of a lease. El Toro has never asserted that Bankruptcy Code § 502(b)(6) caps tort or contract damages that do not result from the termination of a lease.

Whether a post-petition but pre-rejection tenant who commits arson subsequently rejects the lease is irrelevant. Bankruptcy Code § 502(b)(6) simply does not apply and the resulting claim would neither be capped nor treated as if it had "arisen before the date of the filing of the petition" pursuant to Bankruptcy Code § 502(g).

The fact that burning down the building would not be considered a prepetition claim is significant because a post-petition, pre-rejection tort claim not arising from the rejection of a lease is entitled to administrative expense priority, as this Court recognized 40 years ago in *Reading Co. v. Brown*, 391 U.S. 471; 88 S. Ct. 1759; 20 L. Ed. 2d 751 (1968).

As the Ninth Circuit noted in discussing that decision:

> There, the Court determined that an award of tort damages to victims of a fire caused by the Chapter 11 receiver's negligence was entitled to administrative expense priority, despite the fact that victims did not transact with the receiver, nor did the estate benefit from the event. *Reading*, 391 U.S. at 485. In the interests of "fairness to all persons having claims against the insolvent," *id.* at 477, the Court held that tort claims arising post-petition were "actual and necessary expenses" of preserving the estate. *Id.* at 482, 485.

Boeing N. Am., Inc. v. Ybarra (In re Ybarra), 424 F.3d 1018, 1026 n. 10 (9th Cir. 2005).

In short, the Ninth Circuit's concern that extending the cap to cover collateral damage "would allow a post-petition but pre-rejection tenant to cause any amount of damage to the premises -- either negligently or intentionally -- without fear of liability beyond the cap" is based upon a misreading of the statute and the failure to appreciate Supreme Court precedent. It is not necessary to exclude "collateral damages" from the cap in order to avoid an absurd result once it is clear that Congress capped leased rejection damages, rather than damages extraneous to lease rejection.

As another hypothetical, SVCC offers the scenario of a tenant who violates a lease provision prohibiting it from extracting minerals by mining gold.

Again, a claim for conversion of gold mined in violation of a lease simply cannot be characterized as "the claim of a lessor for damages resulting from the termination of a lease" under any rational interpretation of Bankruptcy Code § 502(b)(6). Rather than being capped, the claim would give rise to a debt excepted from discharge in the case of an individual debtor under Bankruptcy Code § 523(2), (4), or (6) if the tort occurred prepetition or be entitled to administrative expense priority if it occurred post-petition.

Finally, SVCC offers the example of a tenant who wrongfully buries nuclear waste on the leasehold property. Brief in Opposition, p. 21. SVCC contends that "the landlord's claim would be limited to a small percentage of future rent despite the fact that the leasehold estate might be unusable for centuries." *Id.*

"The intersection of environmental cleanup laws and federal bankruptcy statutes is," as the Ninth Circuit has observed, "somewhat messy." *California Dept. of Health Servs.v. Jensen (In re Jensen),* 995 F.2d 925, 928 (9th Cir. 1993). Nevertheless, it is clear that deliberately contaminating property with hazardous substances in violation of a lease is not a claim that arises as a result of the termination or rejection of the lease. Consequently, the cap would not apply.

In fact, willfully contaminating property prepetition appears to fall within the exception to discharge for willful and malicious injury by an individual debtor to the property of another entity set forth in Bankruptcy Code § 523(a)(6). If the act occurred post-petition it would constitute a post-petition tort.

SVCC's nuclear waste example is distinguishable from this case in several dispositive

respects. First, as BAP noted, "[t]his is not a case, as SVCC's approach suggests, where one party commits an intentional tort (or even a crime) against another while those parties, as a matter of coincidence, occupy the status of tenant and landlord. Those are not our facts." Petitioner's Appendix D, p. A-66. Second, El Toro has not contaminated SVCC's property. It has failed to remove non-hazardous "goo," "residue" or "debris" created when El Toro washed sand from rock, gravel and fill materials. *Id.*, Petitioner's Appendix D, p. A-63

El Toro was not wrongfully storing the residue on the property or violating the lease in doing so. As the Bankruptcy Appellate Panel found:

> El Toro was allowed by the lease to mine and remove rock, sand, gravel and fill materials from the land. This provision contemplated that El Toro would wash sand from excavated materials, a process that created the "goo," "residue" or "debris" involved in this case.
>
> Incident to its operations, El Toro was authorized by the lease to store materials it mined from the land on the leased premises. Fairly read,

> this provision authorizes El Toro to stockpile the residue.
>
> El Toro committed to remove "'debris deposits" from the leased premises "no later than four (4) months following the date of termination [of the lease]." This provision reflects the parties' understanding that, upon termination of the lease, there may be stockpiles of residue remaining on the leased premises.

Petitioner's Appendix D, p. A-63.

It is also important to remember that Bankruptcy laws do not shield a party who contaminates property with hazardous wastes from criminal prosecution for violating environmental laws or from fines, injunctions, or a contempt citation, as this Court observed in *Ohio v. Kovacs*, 469 U.S. 274, 284 , 105 S.Ct. 705, 83 L.Ed.2d 649 (1985).

C. The Ninth Circuit's Decision Conflicts With Decisions By Other Circuits.

SVCC is also wrong when it asserts that the Ninth Circuit's decision does not conflict with the

decisions of the Sixth Circuit Court of Appeals in *Capitol Industries, Inc. v. Regal Cinemas, Inc. (In re Regal Cinemas, Inc.)*, 393 F.3d 647 (6th Cir. 2004) and the Third Circuit's decision in *First Bank National Association v. FDIC*, 79 F.3d 362 (3d Cir. 1996).

In El Toro, the Ninth Circuit Court of Appeals held that the Bankruptcy Code § 502(b)(6) does not apply to "collateral damages," defined as "damages other than those based on loss of future rental income." *In re El Toro Materials, Inc., supra*, 504 F.3d at 980-981. In *Capitol Industries*, the Sixth Circuit Court of Appeal rejected the argument that the cap did not apply to claims that "did not relate to rent under the lease—such as legal fees, costs for maintaining the premises . . . and real estate taxes ..."*Id.*, 393 F.3d at 649. The Third Circuit reached the same conclusion interpreting a provision of FIRREA modeled on Bankruptcy Code § 502(b)(6) in reliance upon *Kuske v. McSheridan (In re McSheridan)*, 184 B.R. 91 (BAP 9th Cir. 1995), which the Ninth Circuit overruled in *El Toro*. *First Bank*, *supra*, 79 F.3d at 367.

SVCC's assertion that neither decision dealt with "tort damages" misses the point and betrays a misunderstanding of the breadth of the Ninth Circuit's decision. The Ninth Circuit held that the

cap does not apply to "collateral damages," which includes but is not limited to tort damages.

D. The Ninth Circuit Has Decided An Important Question Of Law With Serious Implications.

SVCC's argument that the Court of Appeals has not decided an important question of law is belied by its own recognition of the importance of the case, its citation to numerous conflicting bankruptcy cases throughout the United States, and the impact of the Ninth Circuit decision on the ability of debtor tenants to reject a lease and to reorganize. As one commentator has observed, the decision in *El Toro* "injects an element of uncertainty into a debtor's lease assumption/rejection decision" and "blunts the potency of lease rejection as a vital reorganizational tool." Rapisardi, J., *"El Toro": A Red Flag on Lease Rejection Damages,* New York Law Journal, Vol. 238-No. 95 (November 15, 2007).

SVCC is arguably correct in asserting that "conduct constituting a breach of contract may also be tortious." Brief In Opposition, p. 23.[3] As BAP

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[3] California has historically allowed a plaintiff to sue in tort or contract for the same injury so long as there was no duplication of damages and there was an election of remedies. *Stoiber v. Honeychuck*, 101 Cal.App.3d 903, 919, 932, 162 Cal Rptr. 194

warned, however, excluding SVCC's claim for tort damages[4] for conduct that also breached the lease from the Bankruptcy Code § 502(b)(6) cap will allow SVCC to "succeed in a classic end-run around the will of Congress." Petitioner's Appendix D, p. A-62.

E. SVCC's Arguments Are Not Supported By The Record.

Finally, SVCC makes a number of factual assertions in its Statement of Facts that are unsupported by citations to the record. This includes the extensive discussion of the removal and reclamation requirements allegedly imposed upon El Toro's by its conditional use permit, reclamation

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(1984). In this case, there is obviously a duplication of damages. Moreover, in recent years, the California Supreme Court has substantially limited tort recovery in contract cases. For example, in *Robinson Helicopter Company, Inc., v. Dana Corporation*, 34 Cal.4th 979, 988, 22 Cal.Rptr. 3d 353 (2004), the Supreme Court stated that "the economic loss rule requires a purchaser to recover in contract for purely economic loss due to disappointed expectations, unless he can demonstrate harm above and beyond a broken contractual promise."

[4] It is important to remember that SVCC has never established its entitlement to tort damages and may never do so. The bankruptcy court ruled that the cap would not apply to SVCC's causes of action for waste and nuisance as a matter of law in the context of a motion for partial summary adjudication without deciding the merits of the underlying claims. Petitioner's Appendix E, p. 92.

plan, the California Surface Mining and Reclamation Act, and the Orange County Zoning Code. It also includes SVCC's assertion that it agreed to extend El Toro's occupancy after the lease rejection "based on El Toro's representations that needed additional time to remove the stockpiled Wet Clay ...." Brief In Opposition, p. 7.

In another assertion unaccompanied by a citation to the record and an obvious attempt to suggest El Toro is guilty of bad faith, SVCC contends that it "gave El Toro the right to re-enter the site during the next several months to perform its Reclamation Plan.... El Toro refused." Brief In Opposition, p. 8. The problem with this assertion, aside from the lack of evidentiary support, is the fact that El Toro had already rejected the lease. As such, the premises were not property of the estate and the cost of removing the residue would not have constituted "the actual, necessary costs of preserving the estate" under Bankruptcy Code § 503(b)(1)(A).

In demanding that El Toro incur the cost of cleaning up the site or reimburse SVCC for doing so, SVCC was essentially insisting that its claim was entitled to administrative expense priority on public policy grounds. The Ninth Circuit Court of Appeals rejected the same argument in *Burlington Northern Railroad Co. v. Dant & Russell, Inc. (In re Dant &*

Russell, Inc.), 853 F.2d 700, 709 (9th Cir. 1988), with the observation that Congress alone fixes priorities.

CONCLUSION

For the reasons stated, Petitioner respectfully requests the Court to grant the petition.

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